



Evaluating Public Goods and Regulations: Response

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Response from Louis Kaplow

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Evaluating Public Goods and Regulations

Louis Kaplow's recent paper, "On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy" (Fall 2004, pp. 159–176), begins by offering a new approach to the evaluation of potential public goods and environmental regulations. Providing a public good or improving environmental quality has distributional effects both from the benefits of the public good or improved environment and from the cost of providing that benefit. Kaplow's new approach "neutralizes" these distributional effects via offsetting tax changes and then checks to see whether the "neutralized" version of the policy yields an efficiency gain. We believe that this new approach is a major advance for the evaluation of government policy.

However, Kaplow goes on to argue that under this approach there is no need to consider distributional effects or pre-existing labor supply distortions: simple first-best benefit-cost rules apply. We strongly dispute this claim. Under the particular functional form the paper assumes—where leisure is separable in utility from both private consumption and government spending—second-best considerations are indeed irrelevant, because the effect of distributional considerations exactly offsets that of labor supply distortions. However, under an equally or more plausible functional form for utility—in which government spending is separable from leisure and consumption—the second-best principles

for policy evaluation remain largely unchanged from those shown in the public economics literature over the last three or four decades. Indeed, when willingness to pay for the public good is proportional to income, the distribution-neutral approach yields *exactly the same* results as does prior work. And in more general circumstances, without any restrictions on the utility function, distributional considerations and labor supply distortions remain crucial to policy evaluation under the distribution-neutral criterion (see Williams, 2005).

Thus, Kaplow has offered an original and important approach for evaluating government policy. But under this approach, distribution and labor supply distortions generally remain highly relevant.

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Response from Louis Kaplow

The thesis of my article is that traditional first-best principles, like the Samuelson cost-benefit test and Pigou's injunction to internalize externalities,

provide good benchmarks for policy analysis despite concerns about distribution and labor supply distortion advanced in extensive literatures. The reason is that it is possible to implement such government policies in a distribution-neutral fashion, which in a basic setting holds both distribution and labor supply constant. I appreciate Goulder, Parry and Williams's kind words regarding the importance of my proposed distribution-neutral approach.

Goulder, Parry and Williams suggest, however, that my claim must be qualified if one alters my base-case assumption regarding separability. But I offered an extensive discussion of qualifications (pp. 166–168) that begins by addressing this very assumption. As I explain there, this and other caveats are essentially orthogonal to the literature's two main arguments. The necessary adjustments to first-best prescriptions depend on different factors and, a priori, are as likely to be in the opposite direction from what is called for in prior work. Thus, their assertion that the literature's prescriptions “remain largely unchanged” is incorrect.

Moreover, in reviewing that work (pp. 168–171), I show that the primary source of distortion in the second-best literature on public goods and regulation is an implicit increase in

redistribution. That is, the literature's policy experiments typically build in greater redistribution; the resulting distortion is highlighted whereas the welfare effect of redistribution is ignored. One of my examples of this phenomenon (n. 8) involves the very case of separable public goods that Goulder, Parry and Williams emphasize. This depiction is reinforced by the single instance they identify where prior models would yield the same result as my distribution-neutral approach, for it is precisely the case in which the underlying policy experiment happens to be distribution-neutral.

Finally, as a matter of logic, Goulder, Parry and Williams's introduction of public goods separability cannot upset my argument. Such separability is not inconsistent with the weak leisure separability used in my benchmark case (as n. 8 indicates). Also (as n. 2 mentions), my result is proved in Kaplow (1996) for the case with both types of separability (as well as in a more general setting).

References

- Kaplow, Louis.** 1996. “The Optimal Supply of Public Goods and the Distortionary Cost of Taxation.” *National Tax Journal*. 49:4, pp. 513–33.